

Online Appendix for “Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry”

Management Science

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Appendix A: An Example of Potential Conflicts of Interest

In a July 2013 comment on the SEC’s 2010 Concept Release on the U.S. proxy voting system, Axcelis Technologies Inc., a firm supplying capital equipment for semiconductor manufacturers, commented that even though its board limited the proposed increase in the shares reserved for issuance (under the firm’s 2012 Equity Incentive Plan) to a level that had met ISS’s standard, ISS recommended against the plan just nine days before the company’s 2013 annual meeting. To be conservative, the Axcelis board set the increase in the share reserve at 16% of outstanding shares, as ISS assigned a 19% cap for Axcelis in 2012. In its recommendation, however, ISS determined that a 14% cap was appropriate for 2013.

Axcelis’s independent proxy consultant advised that the firm was unlikely to obtain shareholder approval for the equity plan increase without ISS’s support. Following this advice, the board decided to lower the cap three days before the meeting, an outcome that reduced the number of shares awarded to its employees by 45%. Subsequent to the filing of Axcelis’s revised proxy statement, ISS issued an “Alert,” reversing its recommendation to support the modified amendment to the 2012 Equity Incentive Plan.

One week after the meeting, the general counsel of Axcelis received a phone call from an ISS representative. The representative referenced the stock plan debacle, and suggested that “going forward...

you do have the ability to work with us prior to filing a proxy so you would know to a pretty high degree of certainty what the likely vote recommendation would be... For any type of stock option proposal... essentially, you can model out different share requests before you actually reached the point of filing a proxy.”

Axcelis’s full comment on the Concept Release is available for download at <http://www.sec.gov/comments/s7-14-10/s71410-322.pdf>.

Appendix B: Background and Regulatory Developments

This section explains, in detail, important market and regulatory developments in the proxy advisory industry. In 1988, the Department of Labor issued a letter mandating that pension funds have a fiduciary duty to vote their proxies in the best interest of their clients. This prompted managers of employee retirement plans to seek advice from ISS (founded in 1985) and its competitors Proxy Monitor and the Investor Responsibility Research Center (“IRRC”). ISS merged with Proxy Monitor and IRRC in 2001 and 2005, respectively.

In the 1990s and early 2000s, ISS’s dominance in the industry continued to rise, thanks to growing fiduciary obligations of institutional investors and increased shareholder activism in the aftermath of the dot-com bust. Institutional investors hired proxy advisory firms to help them assess corporate governance practices at public companies.

In 2003, the SEC reinforced fiduciary duties of investment advisers with respect to proxy voting through a widened application of the Investment Advisers Act of 1940. These expanded rules require mutual funds to publicly disclose their voting records, as well as to adopt policies and procedures to ensure that they vote proxies in the best interests of clients. The SEC further issued no-action letters in 2004, clarifying that investment advisers can fulfill their fiduciary duty in a “conflict-free manner” if they vote in accordance with recommendations from an independent proxy advisory firm. These requirements have led to a rapid increase in demand for proxy advisory and governance services. More recently, the shift to majority voting in director elections, the elimination of broker discretionary voting in uncontested elections, as well as Say-on-Pay votes required by the Dodd-Frank Act likely have further increased the influence of proxy advisory firms, as suggested by the Center on Executive Compensation.

Concerns over conflicts of interest and other issues (such as barriers to competition, a lack of transparency, potential inaccuracies and limited engagement with issuers) led to two GAO studies and a Concept Release on the U.S. proxy system issued by the SEC in July 2010. On June 30, 2014,

the SEC issued long-awaited guidance regarding proxy advisory firms, in the form of a Staff Legal Bulletin. The guidance indicates that investment advisers retaining proxy advisors should perform due diligence to ensure that these firms have the “capacity and competency to adequately analyze proxy issues.” Investment advisers need to consider whether proxy advisory firms have robust policies and procedures to “identify and address any conflicts of interest,” and provide current and accurate information. Furthermore, the guidance requires that proxy advisors disclose to the recipients of voting recommendations any significant relationships or material interest, including conflicts of interest arising from providing consulting services to companies. Proxy advisory firms were expected to comply to the guidance before the 2015 proxy season.

The SEC’s move came after similar guidance proposed in Europe. In February 2013, the European Securities and Markets Authority (“ESMA”) recommended that the proxy advisory industry develop an E.U. Code of Conduct that focuses on “identifying, disclosing and managing conflicts of interest; and fostering transparency to ensure the accuracy and reliability of the advice.”

Major proxy advisors

Today, the proxy advisory industry is dominated by just two firms: ISS and Glass Lewis. This duopoly structure has allowed them to have a significant influence on pay and corporate governance policy. Since 1985, ISS has become a leading player in both proxy advisory services and corporate governance ratings. Before its acquisition by private-equity firm Vestar Capital Partners in April 2014, ISS was owned by MSCI Inc., a leading provider of investment decision support tools to investors worldwide. As of 2007, ISS had 1,700 institutional clients, and a market share of 61%, based on clients’ equity assets. Its clients included 24 of the top 25 mutual funds, 25 of the top 25 asset managers, and 17 of the top 25 public pension funds. ISS’s core business includes proxy research and voting recommendations. It also provides web-based voting services and consulting services to corporate issuers through ISS Corporate Solutions, Inc. (“ICS”), a wholly-owned subsidiary of ISS. ICS provides products and services on executive compensation, corporate governance ratings, voting analytics and governance

research. ISS's business model of selling data and consulting services to corporations while advising investors how to vote on proposals of the same issuers has led to charges that ISS is seriously conflicted, according to the Center on Executive Compensation. In 2013, almost 30% of ISS's total revenue was generated from its ICS subsidiary, up from 18% in 2010 (see MSCI Inc.'s annual reports for fiscal years 2010 and 2013). Despite vehement criticism for potential conflicts of interest created by its consulting services, ISS has been reluctant to spin off this business because of its high profitability. Much of the consulting revenue results from charging corporations for use of the ISS compensation model. In fact, some industry experts believe that without its corporate services business, ISS's operations would be much less profitable.

Glass Lewis was founded in early 2003, and has quickly established itself as ISS's main competitor, controlling 37% of the market share in 2007. At the end of 2010, Glass Lewis acquired Proxy Governance, Inc.'s 100 clients after the latter exited the market, further increasing its market share. In 2011, it covered around 23,000 companies in more than 100 countries, inching closer to ISS's coverage of 26,000 companies. A 2004 New York Times article reported that "Glass Lewis has unseated [ISS] . . . from its position as the undisputed leader in the field." Like ISS, Glass Lewis provides proxy research and voting recommendations to institutional shareholders. Glass Lewis's ability to quickly cut into ISS's market share owes partly to the fact that it does not sell corporate governance services to corporations. Many investors view Glass Lewis as less conflicted. A Glass Lewis executive stated in an email: "We do not advise or consult with corporations regarding their proxies; we believe to do so would compromise our ability to objectively evaluate those proxies and advise our clients on how to vote their shares."

After Proxy Governance's exit at the end of 2010, there remain two other for-profit proxy advisory firms, Egan-Jones Proxy Services and Marco Consulting Group. A new firm, ProxyTell, LLC, appears to have entered the market in 2012. They collectively own less than 2% of the market share, and thus are not a part of this research.